Internal Revenue Service

memorandum

CC:TL-N-4048-89
Br2:SMJannotta

date: MAR 23 1989

to: Acting District Counsel, Detroit C:DET
Attention: Margaret A. Satko, Attorney

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: In re: [redacted]
Proposed settlement offer on litigation costs

This responds to your memorandum dated February 22, 1989, requesting authorization to settle the litigation cost issues in the above referenced case. In view of the extensive discussion of the facts and case law contained in your incoming memorandum, we have limited our discussion to those issues directly affecting the appropriateness of the proposed settlement offer. We have also accorded substantial weight to the fact that, as respondent's attorney of record, Ms. Satko is in the best position to judge the relative strengths and weaknesses of the various litigating hazards associated with petitioners' motion for costs where a judgment call on the facts is indicated. Respondent's responses to petitioners' motion and brief in support of motion are due to be filed with the court on or before [redacted].

ISSUE

Whether the litigation cost issues claimed in the amount of $[redacted] should be authorized for settlement in the amount of $[redacted] as recommended by District Counsel.

CONCLUSION

We agree that settlement of the litigation cost issues in the amount of $[redacted] is appropriate inasmuch as there is a substantial likelihood that petitioners would ultimately prevail and that further, if they were to prevail, the amount awarded could reasonably be expected to substantially exceed $[redacted] Authorization, however, is specifically conditioned upon petitioners' providing sufficient proof to establish their satisfaction of the net worth requirements imposed by I.R.C. § 7430(c)(2)(A)(iii).

FACTS

According to information contained in your incoming memorandum, as well as information subsequently provided during the course of telephone conversations between Margaret A. Satko of your office and Santina M. Jannotta of our office, the salient facts are as follows. The substantive issues in the above case were fully conceded by stipulation between the parties. [1] As stated in your memorandum at page 14, it was further stipulated that "petitioners have substantially prevailed with respect to the deficiencies in income tax and the most significant issue presented in the case for each of the taxable years in question. ... [and] that petitioners have exhausted all administrative remedies available to them."

The statutory notice was issued [redacted]. The petition was filed timely on [redacted]. Respondent, through its then counsel, filed a simple admit/deny Answer on [redacted]. We understand that District Counsel received the complete administrative files on or about [redacted]. The Stipulation of Settlement was filed at the time of calendar call in [redacted]. For purposes of our analysis, we have accepted the following as fact: (1) that the issue of petitioners' profit motive in this case should have been conceded at the time for filing Respondent's Answer based on information available in the administrative files in District Counsel's possession at that time and (2) that petitioners did not provide any additional information or new documentation to District Counsel. [2]

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[1] The section 183 issue, which is the main issue here, concerned petitioners' Subchapter S operation of a [redacted] farm (i.e., [redacted]). The determination of a taxpayer's requisite profit motive is a question of fact and relevant factors to be considered are set forth in Treas. Reg. § 1.183-2(b). See, e.g., Eisenman v. Commissioner, T. C. Memo. 1988-467 (losses in [redacted] activity not barred as taxpayer found to have honest profit objective).

[2] We understand that, if she had been in the position to make the call originally, Ms. Satko would have recommended concession of the section 183 profit motive issue based on the information available in the administrative file. We also understand that, assuming such a recommendation had originally been made, it would have been supported by Ms. Satko's reviewers. Based on our own analysis of the information provided for review on the underlying section 183 issue, we tend to agree that concession of the issue of petitioners' profit motive was indicated.

ANALYSIS

Section 7430 provides the exclusive authority for recovery of attorneys fees and other costs of litigation in tax cases filed after February 28, 1983. In those cases commenced after December 31, 1985, involving amounts paid after September 30, 1986, the requirements of section 7430 as modified by the Tax Reform Act of 1986 must be satisfied. Generally, that means the taxpayer here must establish the following: (1) the position taken by the government in the civil proceeding was not substantially justified; (2) the taxpayer prevailed as to either the amount in controversy or the most significant issue(s) in dispute; (3) the taxpayer exhausted all administrative remedies; and, (4) the taxpayer meets the net worth requirements of the Equal Access to Justice Act. In addition, the amount(s) recoverable are limited to reasonable litigation costs. See section 7430(c)(1).

The Service has consistently maintained that the reasonableness of the government's position is to be determined by reference to the Service's post petition litigating position. [3] In cases in which respondent has conceded or settled the underlying substantive tax issue(s) in dispute, courts have usually focused on whether the government acted timely once it had (or reasonably should have had) all the necessary information to concede or settle the matter. See, e.g., Sher v. Commissioner, 89 T.C. 79, 86-87 (1987). The issue then may be restated as whether the actions taken by respondent's attorney of record in settling this case were reasonable when taken. Therefore, in stating that the underlying section 183 issue properly should have been conceded prior to, or contemporaneous with, the filing of the government's answer, we understand you to mean that the post petition litigating position taken by your office was not substantially justified in this case. Because we agree with your assessment that successful litigation of this issue is not reasonably assured, we conclude that settlement on

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[3] As the Tax Court proceedings here were commenced prior to the effective date (i.e., November 11, 1988) of changes to section 7430 permitting recovery by a prevailing party of some costs associated with administrative proceedings, and as we also understand that District Counsel was not involved in this particular case prior to the filing of the petition in Tax Court, we have simplified our discussion somewhat. Although it is not certain that the Sixth Circuit would limit its examination to the Service's post petition conduct in this case in light of its TEFRA decision in Comer v. Commissioner, 856 F.2d 775 (6th Cir. 1988), the government's litigating position on this issue has been adopted by the Tax Court. See: Sher v. Commissioner, 89 T.C. 79 (1987), aff'd, 861 F.2d 131 (5th Cir. 1988); Egan v. Commissioner, 91 T.C. No. 46 (1988).

this point is supportable.

The sole remaining legal issue to be resolved before determining that petitioners are entitled to recover their reasonable costs is whether they can satisfy the pertinent net worth requirements imposed by virtue of section 7430(c)(2)(A)(iii). Ms. Satko has informed us that she has no reason to believe they cannot meet those requirements. Further, she has indicated that she believes adequate demonstration of that fact would be promptly brought forth upon request. Although we will assume for purposes of our discussion, that petitioners' have satisfied this requirement, we impose as a condition precedent to your acceptance of the negotiated settlement offer the restriction that petitioners affirmatively and satisfactorily meet their burden of proof on this point.

We next address the question of whether petitioners' recoverable costs can reasonably be expected to equal or exceed the settlement offer of $[redacted]. In their motion for costs, petitioners requested fees and costs in excess of $[redacted]. Further, we understand that they are continuing to incur costs (presently estimated to be in excess of an additional $[redacted]). A significant portion of the originally claimed costs, however, are attributable to prepetition events. Generally, to be recoverable, costs must be incurred at or after commencement of the civil litigation. An exception has been recognized for expert reports and appraisals which are found to have been necessary for preparation of the litigation or settlement of the case. [4] In evaluating the proposed settlement offer, we have declined to consider costs attributable to prepetition activities other than petitioners' stated cost of the appraisal ($[redacted] and the accountant's projections ($[redacted]. To these costs, we have added the $60 filing fee, $[redacted] in accountant's fees for post petition time spent, and certain attorneys' fees totalling

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[4] The determination of the usefulness of the relevant appraisal and projections here would be a question of fact. In initially including them in the pool of potentially recoverable items, we have relied on Ms. Satko's affirmation that these documents would have been useful to her in settling this case, that they were present in the administrative file, and that they otherwise would have been necessary for preparation of petitioners' litigation of this case.

$[redacted]. [5] Thus, assuming petitioners established that they were otherwise entitled to recover their costs, we estimate that the total of petitioners' recoverable litigation costs to be in the neighborhood of $[redacted]. This assumes further, however, that petitioners can establish that such costs were reasonable as charged.

The burden of proof is on petitioners under section 7430 to establish their entitlement to the litigation costs at issue here. See, e.g., Egan v. Commissioner, 91 T.C. No. 46 (1988). Based on the overall experience of this office, we would normally consider challenging some of the time and costs charged by petitioners' attorneys as unreasonable generally. For example, petitioners filed a [redacted] page brief in support of their motion for costs. This appears to be excessive since most such motions are usually adequately supported by a short memorandum of authorities. However, Ms. Satko has represented that she believes petitioners' costs as charged are reasonable in this case. Moreover, based on the information provided, we can not categorically eliminate any of the submitted costs so as to produce an estimate of reasonable costs in an amount less than $[redacted] when post motion costs are also considered.

Therefore, taking into account all of the potential litigating hazards in this case, we agree with Ms. Satko's overall assessment. Because we conclude that there is a substantial likelihood petitioners will be able to establish that the position taken by the government in the civil proceeding was unreasonable (i.e., "not substantially justified") and because we conclude that the likelihood of limiting petitioners' recoverable

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[5] Petitioners' counsel billed [redacted] hours at $[redacted] per hour (partner's time), [redacted] hours at $[redacted] per hour (associate's time), [redacted] hours at $[redacted] per hour (law clerk's time) and [redacted] hours at $[redacted] per hour (for clerical services). In our evaluation of the proposed settlement offer, we have declined to take into consideration all such prepetition activity. Cf., Stieha v. Commissioner, 89 T.C. 784 (1987) (recoverable costs are costs incurred after commencement of civil proceeding). Moreover, we have declined to place a reasonable value in excess of the statutory limitation of $75 per hour on the partner's services. See: Pierce v. Underwood, 487 U.S. ___, 108 S. Ct. 2541 (1988). Thus, we compute the maximum potentially recoverable attorneys' fees as follows: [redacted] hours at $[redacted] (partner's time) ($[redacted] plus [redacted] hours at $[redacted] (associate's time) ($[redacted] for a total figure of $[redacted]. (We have disregarded the time charged for the law clerk and clerical services for purposes of our evaluation of the settlement offer. We have done this for computational purposes and do not mean to suggest by such elimination that these costs could not, in our opinion, reasonably constitute recoverable items.)

costs to less than $[redacted] is minimal, we agree that acceptance of the offer of settlement is appropriate in this case. Accordingly, we authorize your acceptance of the settlement offer of $[redacted] subject to the following condition, i.e., petitioners must satisfactorily establish that their net worth (measured as of the commencement of litigation) did not exceed the statutory limitations imposed. See section 7430(c)(2)(A)(iii); Stieha v. Commissioner, 89 T.C. 784 (1987).

If may be of further assistance, please call Attorney Santina M. Jannotta at (FTS) 566-3520.

MARLENE GROSS

By: Clifford M. Harbourt
CLIFFORD M. HARBOURT
Senior Technician Reviewer
Branch No. 2
Tax Litigation Division